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TAGS: EINV ETRD ECON RS
SUBJECT: RUSSIA: SPECIAL ECONOMIC ZONES START TO STAND UP

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¶C. MOSCOW 1148

Classified By: ECON M/C Pamela Quanrud for reasons 1.5 (b) and (d).

.1. (C) Summary: As part of ongoing efforts to diversify the Russian economy away from oil and gas, Russia is hoping to attract investment to the high-tech sector, a potential area of natural advantage, in part through the establishment of Special Economic Zones (SEZs). Formally established in 2005, development plans and budgets are now in place for the high-tech and manufacturing zones, incipient infrastructure is under construction, and initial residents are setting up shop. The Ministry of Economic Development and Trade, and Minister Gref in particular, hope these SEZs will attract top-flight companies, but opinions among local representatives of U.S. high tech firms varies. Some would rather see uniform improvements to the investment climate over advantageous conditions at a handful of individual sites. Others, however, cite the opportunity to curry political favor, and potential new business with the GOR, as sufficient reasons to throw their hat into the SEZ ring. End summary.

Investing in Economic Diversification

¶2. (SBU) The recent up-tick in investment in the consumer goods and services and financial sectors is a first faint sign of economic diversification here (Ref A), a trend that senior GOR leadership is working to expand through greater investment in the high tech, manufacturing and other non-energy sectors. In a November 2006 placement in the Washington Post, Minister of Economic Development and Trade (MEDT) German Gref laid out what he called "a systemic approach" to stimulating both domestic and foreign investment -- one of the first such entreaties by a Russian Minister since oil crested the $50 mark. Elements of Gref's plan include the development of technoparks, venture capital funds for innovation start-ups, business incubators, tax incentives for software exporters and firms that invest in R&D activities, public-private partnerships to develop major infrastructure projects, a new state Development Bank (Ref B) and establishment of Special Economic Zones (SEZs).

SEZs: High Hopes

¶3. (SBU) Since Putin signed SEZ legislation in mid-2005, an SEZ Management Agency, RosSEZ, has been established as an

independent body under the MEDT and six sites were selected in late 2005 for technological/innovation and industrial/production zones. In January 2007, the GOR selected an additional seven tourism and recreational zones, and is now considering the creation of port zones. MEDT hopes the SEZs will create 75,000 jobs and generate $4.38 billion in revenue by 2011.

What's Being Offered?

¶4. (U) The GOR hopes to attract investors to the zones with an array of incentives. For the technological/innovation and industrial/production SEZs, the federal, regional and local governments will jointly fund infrastructure development (roads, railroads, communications, power, water, sewerage, schools, health and child care, and recreation areas as well as business and technology transfer centers, and administrative buildings) to the tune of RUR 78.8 billion (about $2.84 billion) through 2010. Over a twenty year period, RosSEZ is slated to provide on-site "One Window" service for companies for all necessary permits and registrations as well as tax and customs assistance. Companies in the zones will enjoy a five-year reduction of social security and profit taxes, five-year exemption from land, property and transport taxes, tax write-offs for R&D, accelerated depreciation of fixed assets, exemption from customs duties and VAT for imported products, and exemption from import duties and taxes for SEZ-produced exports.

¶5. (SBU) In order to qualify for these benefits, firms must register in the local jurisdiction (i.e., cannot be a subsidiary of a company registered elsewhere in Russia) and submit an application form and business plan to a RosSEZ

committee for adjudication within 53 days. For the time being, Minister Gref personally approves all RosSEZ committee decisions. Residents of the industrial/production zones must agree to invest at least 10 million euro over twenty years to build and later upgrade production and other facilities, with first year investment totaling at least 1 million euro. Companies are also expected to finance any employee housing it may choose to build on specially designated SEZ territory.

¶6. (SBU) Technological/innovation SEZs are located in the towns of Dubna (120 km north of Moscow), Zelenograd (22 km west of Moscow), St. Petersburg and Tomsk. Each zone is designated to specialize in specific technologies (Dubna in IT and nuclear technologies; Zelenograd in microelectronics and nano technology; St. Petersburg in hi-tech; and Tomsk in new materials). Industrial/production SEZs are located in Lipetsk and Elabuga (Tatarstan), and are also specialized (the former in household electronics and the latter in automotive and petrochemical production).

¶7. (SBU) In each of the zones we have visited (Dubna, Zelenograd, Lipetsk and Elabuga), initial work is underway on roads, sewage, power, phone and data lines. All six zones have a handful (no more than 6 in any one zone) of approved residents, mostly Russian, some of which have begun building plants or operating in pre-existing buildings. In the case of the technological/innovation zones, the locations were chosen to take advantage of nearby universities and scientific institutes, such as the Joint Institute for Nuclear Research near Dubna (Ref C) and the Moscow Institute of Electronic Technology in Zelenograd. The zones plan to interact closely with the universities and institutes through student internships with SEZ residents, recruitment of local graduates, university tailoring of curriculum to meet resident needs, and shared use of laboratories and other facilities. The two industrial/production zones were selected for their existing infrastructure advantages, as well as proximity to adequate work force.

Build it, but Will They Come?

¶8. (C) The Moscow offices of several U.S. high tech firms already active in Russia (Oracle, Sun Microsystems, Motorola, Intel and Microsoft) expressed doubts that SEZs would fit into their investment strategies. They voiced concerns about the ability of the various levels of government to execute ambitious plans, including provision of truly adequate infrastructure and "One Window" services, and about whether the SEZ regime would survive a change in government. Some commented that the timing for completion of the SEZs (2009) was too late for their business needs. Many advocated improvements to the overall business climate in Russia rather than the creation of isolated havens in select locations, pointing out that companies want the freedom to choose their location and don't necessarily want the government as their landlord. Microsoft's Mikhail Yakushev (please protect), a former deputy minister of IT, more cynically opined that the SEZs would simply allow bureaucrats to line their pockets. S-Terra, a Russian IT firm in Zelenograd, thought the financial benefits were "not worth the effort" of filling out the paperwork to become an SEZ resident.

¶9. (C) We are, however, aware of at least two U.S. companies planning to apply for resident status. Boeing has already told Gref they will open a technical center in Dubna (note: our perception is that Boeing is largely motivated by positive relations with Gref and an ongoing desire to demonstrate their long-term commitment to Russia. End note.) The firm will not move any engineers from its Moscow Design Center, but hopes to attract engineers from Tomsk and other university cities with the promise of good jobs and company-subsidized mortgages. Cisco is considering opening a technical assistance center, a warehouse and a small R&D shop in the Zelenograd SEZ. Cisco does considerable business with MEDT and said they hope to seal new contracts for provision of services to RosSEZ and zone residents.

¶10. (SBU) Some SEZs, in particular Lipetsk, have launched road shows to Europe and Asia, while others told us they will wait until key infrastructure is ready in 2008 to begin recruiting in earnest. Each zone anticipates a majority of Russian residents, but are all keen to attract a healthy representation of foreign, including U.S., firms.

¶11. (C) Comment: Many in the current administration, particularly Minister Gref, are clearly committed to the successful establishment of SEZs as part of their strategy to further economic diversification. Funding has been identified, RosSEZ and local administrations seem motivated, organized and informed, and initial construction work has begun in all zones. In the background is the failure of previous GOR SEZ regimes, which ended up fostering shell company tax havens, a painful lesson the government says it learned from. The question is whether business will feel sufficiently confident in the long-term and competent administration of the zones, and whether they are lured sufficiently by SEZ benefits to move their operations to specific geographic areas. Our soundings indicate that some will chose to do so, but many would simply prefer more generalized (and ambitious) "fixes" to the overall investment climate and many, we would note, established their positions here long before talks of innovation SEZs became fashionable.
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